GOLD SHEETS Middle Market

Vol XXVI No. 8 — *A Loan Pricing Corporation Publication* — August 2019

5 THINGS TO KNOW

1. Direct lenders with deep pockets and increasing scale are stepping up to provide billion dollar-plus commitments to fund large sized mergers and acquisitions.
2. Foreign investors in the US direct lending market risk exposure to higher costs compared with US counterparts, according to a report from financial advisory firm bfinance.
3. Highlights from BDC earnings season, including quarterly results from Ares, TSLX, Barings, Medley, FS-KKR, Monroe, Capitala and Hercules.
4. Investors are seeking additional protection in volatile credit markets by asking companies to increase guaranteed minimum returns on leveraged loans.
5. Asset managers are increasingly making sustainable investment decisions that reflect their own corporate values and those of their investors, but are still under pressure to deliver competitive returns.

Amid aggressive market conditions, LPs more open to non-sponsored direct lending

– by Fran Beyers

Middle market non-sponsored directly lending has historically suffered from negative associations.

This has been fueled by many direct lenders "dabbling" in the non-sponsored space, only to get burned with a few bad deals and subsequently exiting the strategy.

"For every direct lender that meets with an LP (limited partner) pitching the non-sponsored proposition, there are twenty direct lenders telling that same LP that a non-sponsored strategy is excessively risky," said a direct lender.

However, as LPs continue to become more and more sophisticated about the direct lending space from conferences, consultants and improved data, they are learning that structure matters greatly in middle market lending, and private equity-backed deals are starting to become too loose for comfort.

As a result, their openness to non-sponsored lending is starting to grow again for the right managers with a proven track record.

NON-SPONSORED LENDING IS NOT FOR THE FAINT OF HEART

The perception that non-sponsored lending is very risky exists due to challenges around sourcing deals, doing due diligence and managing the credits.

"Finding and originating deals is really hard, underwriting the deals is hard, negotiating the deals is hard, due diligence is very expensive, and monitoring the loan post close is more labor intensive," said a non-sponsored direct lender.

Having a PE-focused origination platform that services 25-40 private equity sponsors that are going to put meaningful equity behind their investments certainly sounds more compelling. The clear majority of direct lending platforms build their entire origination strategy around private equity-backed investments because it is much easier to call on a group of sponsors regularly than it is to find family owned businesses across the country looking for growth capital.

"The sponsors do all the work - if lenders have questions on the business they ask the sponsor

(**MM REVIEW** *cont'd on p. 2*)

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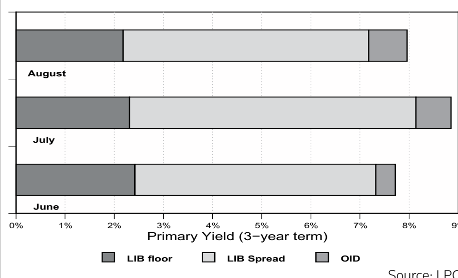

Source: LPC

INSIDE

Section	Page
MIDDLE MARKET REVIEW	1-4
PRICING PULSE	5
IN FOCUS	6
IN THE NEWS	7-17, 24
US MIDDLE MARKET CALENDAR	13
MIDDLE MARKET VOLUME	16
MM LEAGUE TABLES	17
DEAL COMPS	18-23

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WHAT TO WATCH

- At US$218bn YTD, private equity fundraising is on track to hit all-time high.
- 3-month Libor drops to 2.17%, the lowest level in a year and a half.
- Unitranche volume is on track for a record year in 2019.
- Middle market yields tighten to 7.95% so far in August, but are up for the quarter.
- Middle market price hikes outnumber downward flexes by 3:1 in the third quarter.

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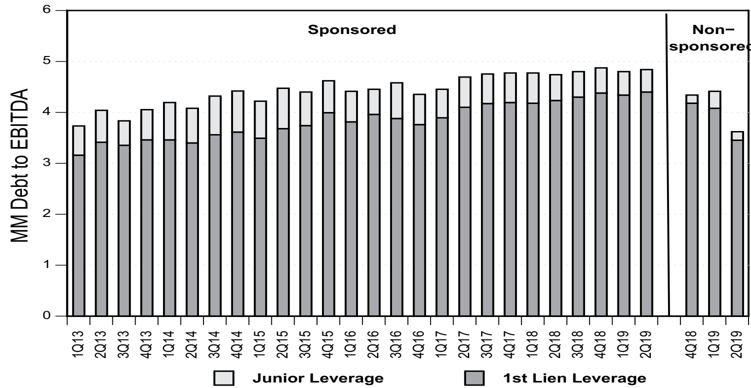
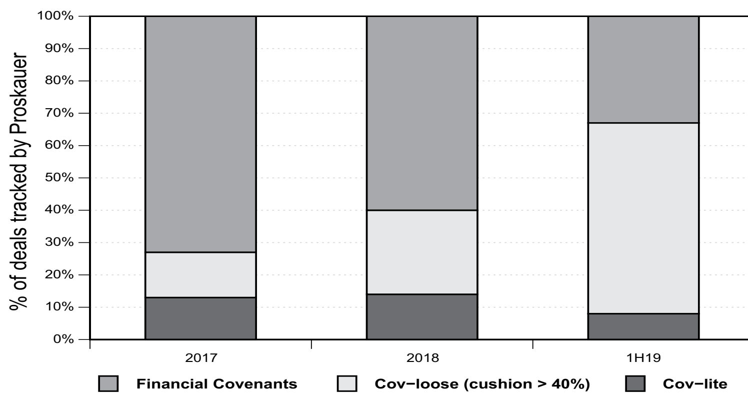
Fig. 1: Non-sponsored deals have less leverage than PE-backed deals



Source: Refinitiv LPC

Fig. 2: Nearly 60% of direct lending deals were cov-loose in 1H19



Source: Proskauer

and get an answer quickly and easily," said a second non-sponsored lender.

Meanwhile non-sponsored direct lending is extremely labor intensive.

"You really need to have the relevant experience, industry expertise, resources, a wide origination funnel, and an angle with the issuers to make this strategy work," said a direct lender.

"We see lenders try to come into the space all the time enticed by the yield and basically throw their hands up and say this is too hard and exit," added a second direct lender.

CALCULATED RISKS = REWARD

But for platforms that know the landscape and the challenges at hand, non-sponsored direct lending can be an extremely lucrative strategy.

"The terms are so much better, spreads are higher by 100bp-150bp, leverage is typically lower by three quarters to one whole turn, and the documents are so much tighter. We get two to three covenants with reasonable cushions and Ebitda is real," added a non-sponsored direct lender.

According to the deals tracked by Refinitiv LPC in 1H19, the average first lien/unitranche spread on non-sponsored deals submitted by direct lenders was 667bp compared to 534bp for sponsored deals.

Meanwhile the average leverage level on direct lending non-sponsored deals was a much lower 3.7 by 4.5 times (1st lien / total) compared to 4.4 by 4.9 times for direct lending sponsored deals in the same period (Fig. 1).

The non-sponsored field is also far less crowded with much less competition to navigate.

"I would say our biggest competitors are the commercial banks, when we are competing on a deal we rarely see another direct lender, these deals are much more bespoke," said the second direct lender.

So how does a direct lender compete with a bank that will lend well south of 350bps? Banks will only push leverage levels so far. Some family owned businesses may need more leverage or a more creative financing option than a commercial bank will provide.

"These companies may need the capital for M&A, to buy out a minority partner, for growth capital or it may be a complicated story that a bank just does not want to take the time to understand – we are more than happy to finance those types of deals and we will get paid generously for it," added a mezzanine lender.

Most of the direct lenders that will play in non-sponsored finance also have a healthy network of sponsored deals, too, as relying solely on non-sponsored lending would be extremely challenging.

Players in the space include but are not limited to Comvest Partners, Fortress, MGG Investment Group, Tennenbaum Capital Partners, BC Partners, TCW, Goldman Sachs Specialty Lending, Brightwood, White Oak Global Advisors, HPS Partners, Cerberus, Monroe Capital, Crystal Financial (owned by Solar Capital) and HIG Whitehorse.

There are also a group of mezzanine providers that focus on non-sponsored lending, including Freedom 3 Capital, Falcon Investment Advisors, ArrowMark Partners, Cyprium Partners and Caltius Capital Management.

Occasionally, sponsored lenders pick up a non-sponsored deal or two based on reverse inquiry from their deep network/rolodex. Owl Rock highlighted a recent example on its first BDC earnings call last month for TransPerfect Global.

In May 2018, Owl Rock extended a US$445m unitranche loan to the language services provider for a buyout of a co-founder with juicy pricing of 675bp over Libor (9.24% all in yield). But in June 2019, the issuer refinanced the debt with a US$400m term loan and US$50m credit facility with a syndicate of banks at 300bp over Libor.

"We earned a 13% gross return, any bank would have loved TransPerfect, but it was a highly complicated deal that took six months to get across the finish line and the issuer wanted to work with one financing source," said Craig Packer, CEO of Owl Rock Capital Corp.

LPS CATCHING ON THAT PE-DIRECT LENDING IS OVERHEATED

In the sponsored lending realm, direct lenders continue to tell LPs that having a big private equity firm behind you with capital is the way to go in middle market direct lending. However, the headlines are worrying investors.

Week after week, news stories hit major news outlets about Ebitda add-backs, the lack of covenants, unrestricted subsidiaries, aggressive leverage levels, and the list goes on and on.

For credits that go south and are not salvageable, it is against PE sponsors' fiduciary responsibility to throw good money after bad. There have been many instances of failed companies where sponsors simply throw the keys to the lender resulting in less than ideal loan recoveries.

"The stigma is that PE has deep pockets and will always support these companies, but it's not always true," said a direct lender. "On the flipside, most family owned businesses have a

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Publisher

Jon Methven

NY Bureau Chief

Michelle Sierra

Senior Market Analysts

Fran Beyers

Diana Diquez

Dave Puchowski

Senior Correspondents

Leela Parker Deo (New York)

Kristen Haunss (New York)

Aaron Weinman (New York)

Correspondent

David Brooke (New York)

Production Manager

Michael Green

For subscription information call:

Direct Marketing

(646) 223-6890

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Fig. 3: Vast majority of direct lending deals has unrestricted subsidiary flexibility

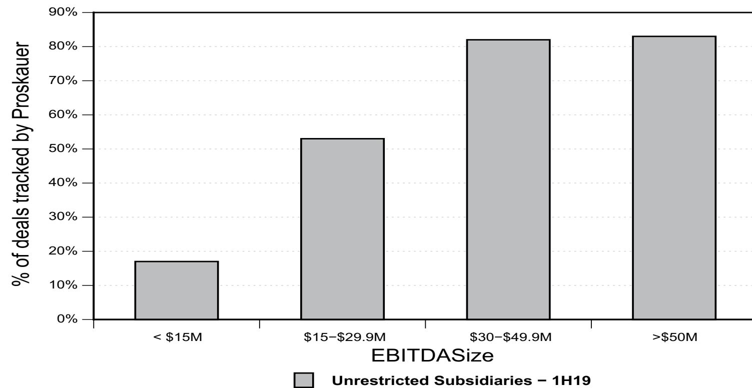
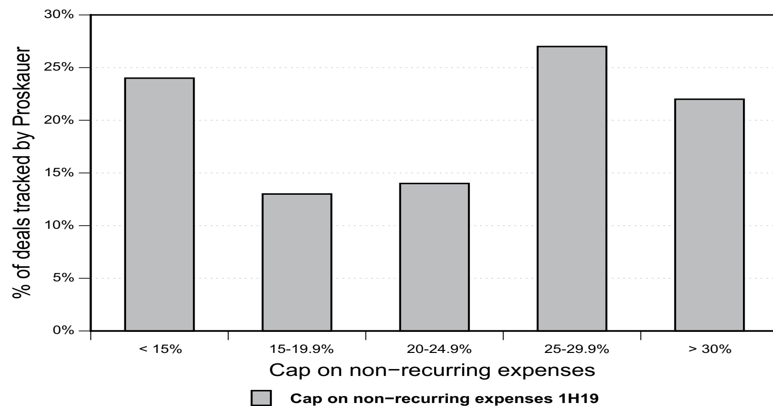


Fig. 4: Nearly half of direct lending deals allow add-backs over 25%



lot of pride and will do uneconomical things to keep their legacy alive, so we find business owners are more risk averse and less likely to financially engineer their deals."

COVENANT-LOOSE

Proskauer, a leading law firm to direct lenders, recently noted in its 1H19 mid-year highlights report some concerning trends of looseness and aggressiveness in PE-backed direct lending deals.

While the share of covenant-lite loans may have dropped to 8% in 1H19 from 14% in 2018, the share of covenant-loose loans skyrocketed to 59% in 1H19 from 26% in 2018. Proskauer defines "cov-loose" as having a covenant cushion of more than 40% (Fig. 2).

"Investors are getting smarter and asking direct lenders about covenants and demanding them in their funds, so hold sizes go way down if a loan is cov-lite, but cov-loose basically meets the criteria of having a covenant so direct lenders can then hold much more of the paper," said a third direct lender, "which is why you are seeing rampant cov-loose lending going on this year.

"You are seeing this trend in first-lien and unitranche deals of the covenants being high, wide and flat and it really does not give lenders much protection at all – it might as well just be cov-lite," said a fourth direct lender.

Furthermore, Proskauer data shows that 53% of issuers with Ebitda between US$15m and US$30m have unrestricted subsidiary flexibility while over 80% of issuers with Ebitda north of US$30m have the flexibility of unrestricted subsidiaries (Fig. 3).

This is surprising given recent headlines such as Petsmart, J Crew, and several others using loose documents to their advantage to move valuable assets to unrestricted subsidiaries.

However, loan investors in J Crew and Petsmart have not yet lost any money; in fact those issuers' document optionality has kept the deals afloat and kept lenders in the game.

"If J Crew did not have the optionality it did, we would have likely seen a default and a low recovery years ago, but the loose docs allowed the company to last longer and pay interest longer," said a CLO investor.

(***MM REVIEW*** *cont'd on page 4)*

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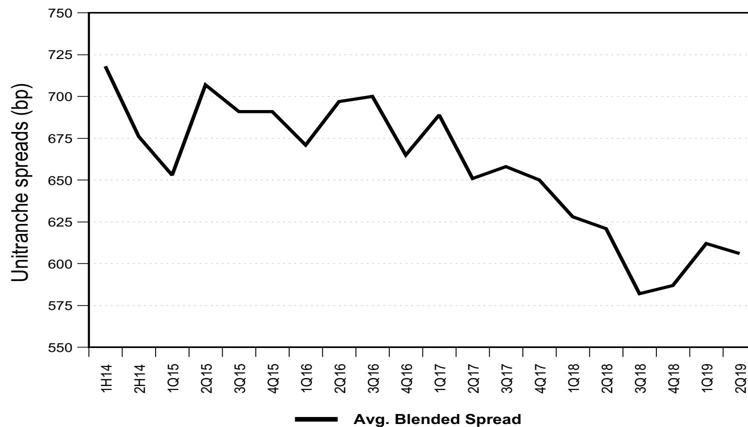
Fig. 5: LTM unitranche spreads collapsed relative to 2014-2017 levels



Source: Refinitiv LPC

However, middle market issuers do not have the scale and nor the same options as large corporate issuers do in keeping the company out of trouble.

With respect to Ebitda add-backs, Proskauer illustrates that close to 50% of direct lending deals in 1H19 allow add-backs for non-recurring expenses of 25% of Ebitda and greater. This was up from just 36% of deals allowing caps this high in 2018 (Fig. 4).

Given how aggressive middle market direct lending deals look today, an LP summed up sentiment: "I have no idea why investors are piling money into US PE-backed direct lending. It is completely uninteresting to me right now. I see HY up 10% this year, spreads on broadly syndicated loans are much wider. How can I justify investing in LIB+475bp paper with aggressive leverage, no liquidity, too much covenant headroom and the terms are as weak as a BSL deal on a company with no scale," said an investor.

UNITRANCHE CAUSING SOME ANGST

Lastly, LPs are also becoming quite aware of the inherent risk on unitranche facilities.

Having a unitranche strategy has been a huge advantage for direct lenders in the current cycle. Being able to take down a US$200m-US$300m deal in one clip means more PE opportunities come through the door.

But as more and more lenders are now able to offer this strategy, terms are being pushed to aggressive levels with spreads coming down meaningfully relative to a few years earlier - making the value proposition less compelling for LPs.

The average spread on unitranche term loans in 2Q19 was 606bp compared to the 650-725bps range from 2014-2017 (Fig. 5).

Furthermore, LPs are starting get uneasy with the leverage that comes along with the term unitranche.

Refinitiv LPC data shows that the average leverage on a unitranche structure was 5.4 times in 2Q19. For deals below US$25m in Ebitda, leverage was 5.2 times while deals over US$25m in Ebitda had a higher leverage point of 5.7 times.

For LPs looking to take simple first-lien risk, these levels feel a bit excessive especially given that they make up a significant share of loan portfolios.

Refinitiv LPC data shows that in 2Q19, unitranche volume hit a new record high at US$9.2bn and made up roughly 30% of loan volume submitted to LPCs private database. Investors and BDC research analysts are more frequently asking managers to break out how much of their first lien portfolio is actually "unitranche" since most managers simply characterize unitranche loans as "first-lien senior secured term loans."

TIME WILL TELL

Only time will tell how sponsored lending default and recovery data will look given aggressive competition this cycle. While there is a growing acceptance of non-sponsored lending, it continues to take a back seat to sponsored lending within LPs investment strategies.

But for lenders who have the resources to appropriately find and lend to non-sponsored issuers, they could come out smelling like a rose in this next cycle.

"We have had mistakes, we have made bad loans, but our team dealt with it, we had the controls in place to work it out and our recoveries have been really good," said a non-sponsored direct lender. "Our LPs have been very happy with their IRRs thus far."

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